No. 13,147

IN THE

United States Court of Appeals
For the Ninth Circuit

Estate of Mabel Cochran, Deceased; Sidney Elmer Cochran and Donald Robert Cochran, Executors, and Joseph E. Cochran,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONERS' OPENING BRIEF.

Eli Freed,
Emmett Gebauer,
1069 Mills Building, San Francisco 4, California,
Attorneys for Petitioners.

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PAUL P. O'BRIEN

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STATEMENT OF THE CASE.

This is a petition to review a decision of the Tax Court denying the validity of a family partnership as between petitioner Joseph E. Cochran and Mabel Cochran, his wife, deceased, and their two grown daughters Bernice Cochran (Johnson) and Winifred Cochran (Irwin). The taxable years involved are 1942 and 1943 and 1944.

There is no dispute as to the evidentiary facts. In the depression years 1936 and 1937, nine members of the Cochran family and the Celli family (the two families are unrelated to each other), all adults, had

discussions, negotiated and came to an agreement to form a partnership, to take over and own and operate the Chevrolet automobile dealership of Cochran & Celli in Oakland, California, a business which was operated as a partnership by the two families since 1915. (R. 95, 96.) From 1906 to 1915 the business was known as the City Front Wagon Works. (R. 94, 95.) In previous years the partners were the heads of the families, Joseph E. Cochran and Bernardo Celli, who were equal partners; and their interests were community property. Joseph E. Cochran and Mabel Cochran, his wife, had four children, two daughters and two sons; Bernardo Celli and Anna Celli, his wife, had two children, both sons. In 1936 and 1937 Bernardo Celli Jr. also called Ben Celli, and Lloyd Celli, the Celli sons, were working in the business. Ben Celli was the salesmanager. (R. 97.) Sidney E. Cochran, the older son of Joseph E. Cochran and Mabel Cochran was assistant salesmanager. (R. 97.) Donald R. Cochran was seventeen years of age and was going to school. Bernice Cochran Johnson and Winifred Cochran Irwin, the daughters, were the eldest children; they were teaching in high schools. Cochran & Celli had been established for many years and the daughters had worked in the business during school vacations, after school and on Saturdays. The business was a very important part of the background in the lives of the parents and children of both families. The parents believed that bringing the children into the business as partners would give them the incentive of ownership and keep them in the business; and in case of death of the elders, the children

would be able to retain the Chevrolet franchise and continue the business. (R. 99.) After many conversations and discussions among all the members of both families, in the latter part of 1936 and during 1937, in November and December of 1937 an attorney was consulted regarding the agreement of the members of both families to organize a partnership of all the members of both families (except Donald Cochran) to take over the business of Cochran & Celli. (R. 100.) A comprehensive partnership agreement was finally completed by the attorney. It was dated the 1st day of January 1938, and signed by all of the parents and children, except Donald R. Cochran. However, paragraph 4 of the agreement contemplated that Donald R. Cochran could be admitted as a partner when he became twenty-one years old and if he agreed to the terms and conditions of the partnership contract. (See Ex. No. 7, R. 39.) A certificate signed by all partners certifying that they were doing business as partners under the name of Cochran & Celli was filed in the office of the County Clerk.

In conceiving and organizing the partnership, there was no thought or consideration given to income taxes. In 1936 and 1937 profits were not very high and tax rates were low; income taxes were nominal. (R. 105, 118.) There was definitely no idea of income tax avoidance.

The investments of capital in the partnership by the children in both families, including the daughters, came from gifts of capital by their parents. Each of

the Cochran children (except Donald) acquired a 7% interest in the capital and each of the Celli children acquired a 10% interest in the capital. The respective capital investment of each partner determined the percentage of interest. The total capital in the business invested by both families, January 1, 1938, was $480,520.38 and the capital accounts of each of the partners on that day shown on the books by the closing balances December 31, 1937, were as follows:

J. E. Cochran	$91,842.88
Mabel Cochran	50,162.80
Sidney E. Cochran	33,636.42
Bernice E. Johnson	33,636.42
Winifred Irwin	33,636.42
Bernardo Celli, Sr.	87,528.52
Anna Celli	53,972.84
Bernardo Celli, Jr.	48,052.04
Lloyd J. Celli	48,052.04

(Ex. No. 10, R. 60.)

A written amendment to the agreement was made February 28, 1945, signed also by Donald R. Cochran (Ex. 8, R. 43), in which it was recognized that Donald R. Cochran was admitted in 1941. This amended agreement set forth the percentages of interests in the partnership of all of the partners shown on the books beginning 1938 to and including the time of the amended agreement. There was very little change in the percentages of interests of Sidney, Winifred and Bernice Cochran through the years 1938, 1939, 1940, 1941 and 1942 and there were no other gifts of partnership interests from J. E. Cochran and Mabel Cochran to their children until 1941 when they each

made a gift of $4,000.00 to Donald R. Cochran; again in 1942 they made gifts of $4,000.00 to each of their children, and in 1943 and 1944 they made gifts of $3,000.00 to each of their children. (Exs. No. 1 and No. 2, R. pp. 24 and 25.)

The partnership agreement provided for substantial capital contributions to the partnership by each of the partners and the agreement expressly provided that each partner was the owner of the portion of the business based on the percentage of capital of each partner. The percentage of capital determined the percentage of partnership profits of each partner. The agreement carefully provided for principal management of the business by J. E. Cochran and Bernardo Celli; however, in the event of the death of one of them, the management duties were to be taken over by his oldest surviving son. (Paragraphs 5 and 9.) The term of the partnership was one year, subject to its continuation from year to year thereafter if thirty days' notice in writing were not given by any one of the partners indicating a desire to dissolve the partnership. (Paragraph 12.) Withdrawal from the partnership was permitted as a matter of right and in case of retirement of any one of the partners, the partnership was to be dissolved and the book value of the withdrawing partner's interest was to be paid to such partner over a period of five years, 10% within sixty days after the effective date of retirement and the balance in installments of not less than one-fifth each year thereafter; the balance was subject to payment of interest of 5% per annum. (Paragraph 13.)

The agreement further provided that the real property in the partnership which was substantial, was to be transferred to the two oldest sons of the Cochran and Celli families and held in trust by them for the benefit of the partnership. This was done. (Paragraph 24, Ex. No. 7, R. 42 and Ex. No. 9, R. 52.)

The capital accounts of all of the children, including Bernice Cochran and Winifred Cochran, were very substantial each year, beginning with 1938; the distributive net profits of the partnership were credited to each partner's capital account each year. (Ex. No. 10, R. 60.) The total capital used in the business each year commencing with 1938 through 1944 was large. The assets in the business ranged from about $750,000.00 in 1938, to about $1,265,000.00 in 1944. The real property and equipment for each year including 1942 and 1943 and 1944, which are the years directly involved herein, averaged 60%, more or less, of the total capital of the partners. The other assets such as cash, receivables and inventories (less a small percentage of liabilities) accounted for the remainder of the capital. (Exs. No. 15, 16, 17, 18, 19, 20, 21, R. pp. 62-75.)

The services of the partners who worked in the business were compensated for by payment of salaries which were subtracted from the partnership income to arrive at net profits distributable to the partners. (Ex. No. 11, R. 60.) Bernice Cochran and Winifred Cochran who did not work in the business received no salaries and their profits from the business were limited to a return on their capital investments. Each

partner, including Bernice and Winifred Cochran, had the right to withdraw money from the business and they made withdrawals within reason, particularly within the years in issue. (R. 110, 174.) The business had a great need for capital. It was not until after the war just ended that the business was able to pay cash for its purchases of cars. (R. 112.)

Although the partnership agreement (Par. 5, R. 31) carefully provided for management control by J. E. Cochran and Bernardo Celli, actually the business was managed with the assistance of the sons who were department heads. The provision for management control was not for the personal advantage of the parents; its purpose was to provide for easy settlement of any disputes among the partners and to give each family an equal voice in the business since the greater number of partners was on the Cochran side. (R. 150, 163, 172.)

In 1937, Bernice Cochran was twenty-seven years old (R. 146) and Winifred Cochran was twenty-five years old. (R. 160.) They had graduated from the University of California and both had B.A. and M.A. degrees. They had a background of having worked in Cochran & Celli on Saturdays, after school and during school vacations. (R. 170.) Before signing the partnership agreement of January 1, 1938, they discussed and understood its provisions. Bernice Cochran was about to get married and she weighed carefully whether to sign the agreement in view of the legal liability involved. (R. 149.) She talked it over with her husband-to-be before coming to a decision. Bernice Cochran testi-

fied that her contribution to the business was equal to the others to the extent of her capital investment which was "earning capital" for the business and also since she left her profits in the business "to build the business up to its present size". She regarded her investment in the business as a good, sound investment. (R. 157.) It was Winifred Cochran's understanding (R. 167, 168) that she and her sister could if they wished have elected to work in the business for salaries or that they could elect not to work and receive only their share of profits based on their percentage of capital.

Bernice and Winifred Cochran received at least once each year financial reports of the business showing the annual net profits of the business, their shares their drawings, and all of the capital accounts including their own. (R. 151.) (See Exs. Nos. 10, 11 and 12, R. 60.) The daughters were aware of and recognized from the beginning that they had the right as provided in the partnership agreement to retire from the partnership on notice and withdraw their entire investments. (R. 151, 152.) They both showed a great interest in the progress of the business. They kept informed about the increase in their investments from financial statements and discussions with partners. (R. 168.) Whenever a new piece of property was to be purchased, they knew about it ahead of time (R. 164, 168), its location, its purpose and so on. In 1942 or 1943 before Cochran & Celli bought the location of its main place of business for $200,000.00 (R. 112, 113), Winifred Cochran investigated the property. She

looked at the property and discussed it with the other partners in her family.

In July 1948, a corporation was organized and Bernice and Winifred Cochran and the other partners received shares of capital stock for their shares of net worth in the partnership. (R. 155, 167.)

The members of the Celli family, who were entirely unrelated to the Cochrans, after due deliberation, accepted both Bernice and Winifred Cochran in the business as binding partners and signed the partnership agreement to such effect. (R. 171.)

SPECIFICATION OF ERRORS.

The Tax Court was clearly in error in finding that:
1. There was no bona fide intent on the part of the copartners of Cochran & Celli and the two Cochran daughters, Bernice and Winifred, either when the partnership was formed or at any other time during the taxable years 1942, 1943 and 1944, that the two Cochran daughters were to be joined with members of the existing partnership of Cochran & Celli for the purpose of carrying on business as a partnership; and 2. Bernice Cochran Johnson and Winifred Cochran Irwin were not valid partners for income tax purposes in the business of Cochran & Celli during the years 1942, 1943 and 1944. (R. 191.)

ARGUMENT.

Counsel have struggled long and hard to comprehend how the Tax Court could have read the record in this case and have failed so completely to recognize the Cochran & Celli partnership business as the old-time traditional family business which has done so much to build up the strong family economic backbone of our country; and that for years and years daughters as well as sons have been given partnership interests in such businesses, interests which are not sham and colorable, but interests which are as real as those of sons and which have been honorably recognized and adhered to.

There just is no factual support for the Tax Court's ultimate findings that there was no bona fide intent on the part of the copartners of Cochran & Celli to accept Bernice and Winifred Cochran as members of the partnership of Cochran & Celli for the purpose of carrying on business as a partnership, and that Bernice and Winifred were not true partners during the years 1942, 1943 and 1944. The premise upon which such ultimate findings is predicated is that their investments of capital in the business originated with their parents, that neither of them performed any services for the new partnership, and that they did not share in the management or control of the partnership. As a matter of income tax law this premise as a predicate for said findings of the Tax Court clearly and erroneously ignores other significant realistic factors existing in the Cochran & Celli

partnership, particularly the importance of capital and the business purpose which it serves, as the chief income producing factor in the business. The findings of fact of the Tax Court, while presumptively correct, are not conclusive on review. (*Walsh v. Commissioner,* 8 Cir., 170 F. (2d) 535, 539; *Stanchfield v. Commissioner,* 8 Cir., 191 F. (2d) 826, 828.)

Whether for federal income tax purposes a partnership exists is a question of fact to be determined, as any other fact, from all the evidence, including the partnership agreement and the conduct of the parties in the execution of its provisions, and if upon a consideration of all the facts it is found that the partners joined together in good faith to conduct the business, having honestly agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributors should in every respect participate in the distribution of the profits, that is sufficient for the recognition of a partnership for federal income tax purposes. (*Commissioner v. Culbertson,* 337 U.S. 733, 734, 735, 69 S. Ct. 1210, 1215, 93 L. Ed. 1659, 37 A.F.T.R. 1210; *Stanchfield v. Commissioner,* supra; *Greenberger v. Commissioner,* 7 Cir., 177 F. (2d) 990, 994.) That is clearly the case in Cochran & Celli.

Petitioners believe that the Tax Court erroneously made its determination that no valid family partnership existed with respect to the two Cochran daughters by a strict application of the "vital services-original capital" test laid down in the *husband* and

wife partnership cases of *Commissioner of Internal Revenue v. Tower,* 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135; *Lusthaus v. Commissioner,* 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679.

What the United States Supreme Court said in those cases regarding the absence of facts meeting such tests must be considered in connection with the particular facts of those cases. In *Greenberger v. Commissioner of Internal Revenue,* 177 F. (2d) 990, 992, the court made the following observations with respect to said cases:

> "* * * The controlling factor in those decisions, so it seems to us, is that the Tax Court had found that there was no real partnership and no intent to carry on a business as such, and there runs through the Tower and Lusthaus decisions, especially the former, the thought that the partnership device was resorted to as a sham for the purpose of evading income taxes. For instance, in the Tower case the alleged gift from the husband to the wife was made three days before the partnership was formed, and it was only a book transaction. There was no real transfer of property to her over which she exercised dominion or control. The wife used the income, 327 U.S. at page 291, 66 S.Ct. at page 538: 'only for purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed.' This led to the observation, 327 U.S. at page 292, 66 S.Ct. at page 538, 'Consequently the result of the partnership was a mere paper reallocation of income among the family members. The actualities

of their relation to the income did not change.' A similar situation is disclosed in the Lusthaus case. The court stated, 327 U.S. at page 296, 66 S.Ct. at page 540: 'His wife was not permitted to draw checks on the business bank account. * * * Neither partner could sell or assign the interest ascribed by the partnership agreement without the other's written consent. * * * no withdrawals were to be made under the partnership agreement unless both partners agreed.' "

The *Tower* and *Lusthaus* cases involved tax avoidance schemes; they were obviously not bona fide and there was clearly no good faith intent to have a business partnership.

The United States Supreme Court granted certiorari in *Commissioner of Internal Revenue v. Culbertson,* supra, because it was clearly necessary to give further consideration to the family partnership problem. The *Culbertson* case originated in the Tax Court of the United States and the Tax Court erroneously focused its attention entirely on the concepts of "vital services and original capital" and simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the *Tower* case. The Supreme Court recognized that an absence of vital services and participation in management and control of the business or original capital are important factors to be considered in determining whether there was a bona fide intent of the parties to join together as partners. The court said, however,

"* * * But such a determination is not conclusive, and that is the vice in the 'tests' adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The Tower case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent." (337 U.S. 733, 744-745, 69 S. Ct, 1210, 1215.)

On the subject of the importance attached to the factor of "original capital," the court addressed itself as follows:

"The Tax Court's isolation of 'original capital' as an essential of membership in a family partnership also indicates an erroneous reading of the Tower opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in Helvering v. Clifford, supra. The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be

considered the property of the donee for tax, as well as general law, purposes. In the Tower and Lusthaus cases this Court, applying the principles of Lucas v. Earl, supra; Helvering v. Clifford, supra; and Helvering v. Horst, supra; 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75, 131 A.L.R. 655, found that the purported gift, whether or not technically complete, had made no substantial change in the economic relation of members of the family to the income. In each case the husband continued to manage and control the business as before, and income from the property given to the wife and invested by her in the partnership continued to be used in the business or expended for family purposes. We characterized the results of the transactions entered into between husband and wife as 'a mere paper reallocation among the family members,' noting that 'The actualities of their relation to the income did not change.' This, we thought, provided ample grounds for the finding that no true partnership was intended; that the husband was still the true earner of the income."

It is quite evident that the Tax Court decided that Bernice Cochran and Winifred Cochran were not valid partners for income tax purposes in Cochran & Celli for 1942, 1943 and 1944 because they did not perform any services for the partnership or participate in the management and control of the business, and because their investments of capital in the business did not originate with them but came from their parents. (R. 192.) A careful reading of the Tax Court's opinion below leaves no doubt that the so-

called *Tower* and *Lusthaus* tests were applied to the Cochran & Celli family partnership despite *Culbertson* and there should be no question whatsoever that the factual situations are entirely different. It is submitted that a finding that there was no bona fide intent to form and do business as partnership by the application of the vital services and original capital tests, without proper consideration of the other material facts, is legally erroneous in view of the decision of the Supreme Court in *Commissioner of Internal Revenue v. Culbertson,* supra.

Apparently the effort of the United States Supreme Court in *Commissioner v. Culbertson* to clarify its meaning in the *Tower* and *Lusthaus* cases was not entirely successful. In *Greenberger v. Commissioner,* supra, the Commissioner asserted that *Culbertson* represented only an affirmation of the rationale of *Tower* and *Lusthaus.* However, the Eighth Circuit Court doubted the validity of that contention (p. 992). That there has been confusion, uncertainty and misapplication of the meaning of the decision of the Supreme Court in *Commissioner v. Culbertson* by many court decisions is emphasized in the recent case of *Alexander v. Commissioner of Internal Revenue,* 5th Cir., No. 13482, March 6, 1952, P-H Tax Service Paragraph 72,337, Footnotes (2) and (3).

> "In Sec. 7 of the Senate Finance Committee Report on H.R. 4473, Proposed Revenue Act of 1951, dealing with family partnerships, and in the Ways and Means Committee Report on the

same subject, the present confused state of the law is thus summarized:

" 'Section 339 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. *Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.*

" 'Although there is no basis under existing statute for any different treatment of partnership interests, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property. Many court decisions since the decision of the Supreme Court in Commissioner v. Culbertson (337 U.S. 733 [37 AFTR 1391]) have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one

member of a family to another, where the donee performed no vital services for the partnership. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated by a desire to benefit the partnership business. Others seem to assume that a gift of a partnership interest is not complete because the donor contemplates the continued participation in the business of the donated capital. However, the frequency with which the Tax Court, since the Culbertson decision, has held invalid family partnerships, based upon donations of capital, would seem to indicate that, although the opinions, often refer to 'intention', 'business purpose', 'reality', and 'control', they have in practical effect reached results which suggest that an intrafamily gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in Commissioner v. Tower (327 U.S. 280 [34 AFTR 799]) and the opinion of the Supreme Court in Commissioner v. Culbertson (337 U.S. 733 [37 AFTR 1391]), which attempted to explain the Tower decision, afford any justification for the confusion is not material—the confusion exists.' (Emphasis supplied.)"

"(3) Sec. 7 of the Senate Finance Committee Report on H. R. 4473, etc., continues:

" 'The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of Helvering v. Clifford (309 U.S. 331). The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. *All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale.*

" 'Not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationship among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances,

will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.

" 'Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner.' (Emphasis supplied.)"

Turning again to the facts in the case at bar. It is quite clear that the Tax Court recognizes that actually there were valid gifts of capital in the business of Cochran & Celli to Bernice Cochran and Winifred Cochran (R. 192); this, and also by virtue of their rights under the partnership agreements, the crediting of capital to their investment accounts in the same manner as such capital was credited to all the accounts of all the partners, the actual crediting of their shares of net profits to them as in the case of all partners, their right to make withdrawals from the partnership (R. 174), especially the withdrawals as found by the Tax Court during the years 1942,

1943 and 1944, all clearly establish definite ownership of substantial capital in the partnership business by Bernice Cochran and Winifred Cochran. The objection of the Tax Court to recognition of the capital owned by the two daughters as grounds for their acceptance as partners for business purposes is based upon the testimony of Joseph E. Cochran that the reason he and Mrs. Cochran made the gifts of community capital to their daughters and brought them into the partnership was to give them equal treatment with the sons. The Tax Court said (R. 192): "While his motive was commendable, the fact remains the evidence fails to show the existence of any business purpose for bringing either of the two daughters into the partnership or that there was a bona fide intent that the two daughters be joined as partners in the business in question." In other words, the Tax Court holds that even though the daughters actually acquired and owned capital in the business and withdrew for their own personal use profits from the business during 1942, 1943 and 1944, they were not business partners because the gifts of capital were not made to the daughters for business reasons. This presents a curious anomaly commented on by the Seventh Circuit Court in *Greenberger v. Commissioner,* supra (p. 993). A curious anomaly indeed would be presented if the petitioners were required to account for and pay a tax upon income which they had no right to receive but which right existed solely and exclusively in the two daughters. It must be conceded that the two daughters had every right to their part-

nership capital and to their partnership income and the daughters no doubt could have successfully maintained an action against petitioners to recover their part of the partnership income had petitioners attempted to take or receive such income as their own.

Very recently, February 19, 1952, recognizing the need for further clarification of the principles governing the recognition of family members as partners for income tax purposes in cases of partnerships organized before January 1, 1951, in view of the amendment to the revenue laws clarifying partnerships organized after January 1, 1951 (Revenue Act of 1951, Sec. 340 (b); Internal Revenue Code, Sec. 191), the Commissioner of Internal Revenue issued a mimeograph stating the present position of the Bureau of Internal Revenue for taxable years beginning prior to January 1, 1951, with respect to family partnerships in which capital is a material income-producing factor. (Mim. 6767; P-H 1952 Tax Service Paragraph 76,179.) It is submitted that the sense of this mimeograph now brings the position of the Commissioner of Internal Revenue (respondent) in line with the position of the petitioners herein. The mimeograph states that if a questioned partner is the real and not a sham owner of an interest in the capital of a partnership business, and if such capital is necessary to the conduct of the business, such questioned partner is ordinarily entitled to recognition and that this is so whether or not he or she performs any services for the partnership. The mimeograph also states

that the Bureau does not adhere to the position that there is an absence of a required business purpose if a gift or other antecedent family transaction does not benefit the business in some way. Under the heading, "Motive and Business Purpose", in paragraph 3 on page 7, the mimeograph states,

> "* * * An individual is entitled freely to dispose of his or her property so far as the income tax law is concerned and may give or sell interests in a business to members of his family. The question with which the law concerns itself is whether the individual has really done so. There is no requirement that intra-family gifts be *motivated* by a business purpose, which frequently they would not have, before the donee may be recognized as the owner for income tax purposes of the property given to him, and the same is true of other antecedent family transactions." (Our emphasis.)
>
> "The *Culbertson* opinion stated a test of intent, whether 'the parties in good faith *and acting with a business purpose* intended to join together in the present conduct of the enterprise.' The Bureau considers that the test of business purpose may be satisfied by the single fact (if it be a fact) that the questioned partner has invested in the business money or property, **useful to the business** of which he or she is the real owner under the principles stated in section 1 hereof, even though such money or property had already been used in the business before the questioned partner acquired any interest therein. * * *"

It is clearly evident in the case at bar that capital is an extremely important factor in the business of Cochran & Celli. (R. 112 and Exhibits Nos. 15-21, R. 62-75.) The capital consists of substantial real property, equipment, inventories, receivables, cash, etc. It should be observed that all partners rendering services received reasonable compensation for such services and such salary income was taxable to them. (R. 110, 111; Ex. No. 11, R. 60.) Only the income attributable to capital was credited to the capital accounts of the daughters. (R. 111.) (This is no different from the periods in 1943 and 1944 when Sidney Cochran and Lloyd Celli were away from the business and received no salaries and were credited only with the income attributable to their capital. (R. 60, Ex. No. 11, R. 177.))

It is of some importance to note that the United States Court of Appeals, Fifth Circuit, in No. 13544, on March 6, 1952, again reversed the Tax Court in *Culbertson* following the remand of the case by the United States Supreme Court in *Commissioner of Internal Revenue v. Culbertson,* supra. (P-H Tax Service, Paragraph 72,336.) The Fifth Circuit Court held that the contribution of capital by the questioned partners contemporaneously with their admission into the partnership qualified them to be recognized as real partners without the necessity of showing rendition of services.

It is submitted that in essence the meaning of the *Tower, Lusthaus* and *Culbertson* cases in respect to

the case at bar is that if the questioned partnership is not a sham, that is to say, is not an income tax avoidance device but, on the other hand, has been utilized for good faith reasons, the partnership must be recognized for income tax purposes if the income in question is attributable to capital used in the producing of income in the business really and truly owned by the questioned partners. (See *Greenberger v. Commissioner,* supra, at 992, 993.) In *Alexander v. Commissioner of Internal Revenue,* supra, at page 72,418, the court said:

> "If there is anything which emerges with clarity from the decision in the Culbertson case, supra, and from the reports of the committees of Senate and House, quoted in notes 2 and 3 supra, it is that the artificial and so-called objective tests of the existence of a partnership, set up in the Tower and Lusthaus cases as conclusive, are not such. The question in each case is one of fact to be determined like any other fact question upon the evidence as a whole, and, as stated in the Committee Reports, 'The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members.'
>
> "It, therefore is, and remains, true that the acid test for determining the question of the reality and validity vel non of a family partnership is to be found in the answer to the question: Was the arrangement real, honest and bona fide, so that all the ordinary incidents and effects of an agreement of partnership flow, each partner bound for the losses, each sharing in the profits,

> in accordance with his agreement? If the answer is yes, whatever may be found to be the intent or results of the parties taxwise, there was a partnership. By the same token, if the answer is that the agreement was not real, with the intent and result that a partnership be created, but a sham, a fraud or a pretense, so that the reality behind the partnership form when unmasked shows itself to be the contrary of what was pretended, there is no partnership, whatever may have been the intent or result taxwise."

In the long family deliberations in 1936 and 1937, preceding the organization of Cochran & Celli, there was no thought of income tax avoidance. (R. 105, 118.) The partnership was planned and organized in good faith for good, valid, sound family business reasons. Joseph E. Cochran and Mabel Cochran, the parents of Bernice and Winifred Cochran, derived no economic enjoyment or benefit to their own personal advantage from the gifts of capital in the business which they made to their daughters. Gifts of capital were made to the daughters in the same way as to the sons, and just as effectively. The record clearly shows the separate identity and ownership of the invested capital accounts of the two daughters. (R. 60.) See: *Lucas v. Earl,* 281 U.S. 111, 74 L.Ed. 731; *Helvering v. Clifford,* 309 U.S. 331, 84 L.Ed. 788; *Burnet v. Leininger,* 285 U.S. 136, 76 L.Ed. 665. The partnership agreement, the terms of which are applicable to all of the other partners, including persons unrelated to the petitioners or the daughters, also

clearly stated that the daughters are the owners of the capital in the business allocated to them. (Paragraph 3, R. 30.) Paragraph 13 (R. 36) also specifically gives the daughters as partners the right to withdraw from the partnership upon thirty days' notice and take out of the business the book value of their interest required to be paid to them, together with interest on the unpaid balances as follows: 10% on the effective date of retirement and 20% of the balance within a period of five years from the date of retirement, but no less than one-fifth of the balance to be paid each year during the period of five years. It cannot be doubted that the capital and profits which the daughters owned and which they allowed to remain in the business served a business purpose (the same business purpose as served by the capital of their brothers) and that the association of the daughters with the other partners in the partnership thereby served a valuable business purpose. The daughters being bona fide owners of capital in the business, it must follow, must it not, that since their capital served a useful business purpose, there was a bona fide intent on the part of the daughters, their parents and the other partners that they should all be associated and joined together as partners in the business? Not only were the daughters entitled to their capital and profits attributable to such capital, but they were also obligated to bear losses and were liable not only as partners but contingently as individuals for any losses. In other words, they were not

less liable for the losses and obligations of the business than any of the other partners.

It should also be remembered that the daughters were accepted as partners by non-related persons, viz., the members of the Celli family, and this is an important factor to be considered as evidencing a valid partnership. (See *David S. Sherman v. Commissioner,* CCH Dec. 18,708(M), Dec. 20, 1951; *Edward A. Theurkauf,* 13 T.C. 529, CCH Dec. 17,226; Note: *Burnet v. Leininger,* 285 U.S. 136, 76 L.Ed. 665.)

If the daughters were acceptable as partners in the judgment of the members of the Celli family, to their brothers, and to their parents, the Tax Court cannot legally substitute its judgment for their judgment. In *Stanchfield v. Commissioner of Internal Revenue,* 8 Cir., 191 F. (2d) 826, p. 828, the court said:

> "* * * The Tax Court may consider the facts of capital contribution and services rendered to the claimed partnership upon the question of the intent of the parties, but it may not substitute its judgment for that of the parties. Id.,* 337 U.S. at page 745, 69 S.Ct. at page 1215, 93 L.Ed. 1659. Greenberger v. Commissioner, 7 Cir., 177 F.2d 990, 994; Nelson v. Commissioner, 8 Cir., 184 F.2d 649; Funai v. Commissioner, 4 Cir., 181 F.2d 890."

It is, therefore, submitted that the findings and decision of the Tax Court below are clearly erroneous

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and that the decision should be reversed with directions to enter a decision for the petitioners.

Dated, San Francisco, California,
April 2, 1952.

Respectfully submitted,
Eli Freed,
Emmett Gebauer,
Attorneys for Petitioners.